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IN THE

Supreme Court of The United States

OCTOBER TERM, 1975

No. 75-1065

JOHN NUVEEN & CO., INC., a corporation, INVESTORS SYNDICATE OF AMERICA, INC., a corporation, and INVESTORS DIVERSIFIED SERVICES, INC., a corporation,

Petitioners,

vs.

HENRY T. SANDERS,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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vs.

HENRY T. SANDERS,

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners John Nuveen & Co., Inc., Investors Syndicate of America, Inc. and Investors Diversified Services, Inc. respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this action on October 30, 1975.

OPINIONS BELOW

The Court of Appeals has rendered two opinions in separate appeals in this action. The more recent opinion is reported at 524 F.2d 1064 (1975) and is printed in the appendix to this petition (A. 1-19). The opinion of the United States District Court for the Northern District of Illinois, Eastern Division, from which that appeal was taken, not officially reported, is printed in the appendix to this petition (A. 20-48). The prior opinion of the Court of

Appeals in this action is reported at 463 F.2d 1075 (7th Cir. 1972), *cert. denied*, 409 U.S. 1009 (1972), and is printed in the appendix to this petition (A. 49-64).* The two orders of the District Court from which the first appeal in this action was taken are also printed in the appendix (A. 65-68).

JURISDICTION

The judgment of the United States Court of Appeals for the Seventh Circuit sought to be reviewed was entered on October 30, 1975. This petition for certiorari was filed within ninety days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Is a promissory note with a maturity of ninety days a security subject to the provisions of the Securities Exchange Act of 1934, notwithstanding that the definition of "security" in Section 3(a)(10) of that Act expressly excludes "any note . . . which has a maturity at the time of issuance of not exceeding nine months"?

2. Absent a finding of deliberate or intentional fraud or of reckless or willful conduct or of knowledge of another's fraud, may a dealer in short-term promissory notes be subjected to liability for damages under Rule 10b-5 under the Securities Exchange Act of 1934, an issue similar to that now under advisement in this Court in *Ernst & Ernst v. Hochfelder*, 503 F.2d 1100 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975) (No. 74-1042)?

3. In light of this Court's opinion in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), may a dealer in short-term promissory notes who purchases and resells

* Unless otherwise noted, all references to the Court of Appeals' action are to its more recent opinion.

such notes in reliance on an unqualified audit report of the issuer's independent accountants be liable for damages under Rule 10b-5 for failing to examine the accountants' working papers, notwithstanding that under the express liability provisions of Section 11 of the Securities Act of 1933 an underwriter is specifically excluded from liability if he relied upon the report of an expert, such as an independent public accountant?

4. Did the Court of Appeals correctly determine the duty of investigation of a dealer in short-term promissory notes under the federal securities laws in light of the unique nature of the market for such notes?

STATUTES AND RULE INVOLVED

Sections 2(11), 3(a)(3), 11 and 12 of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. §§ 77b(11), 77c(a)(3), 77k and 77*l*, Sections 3(a)(10) and 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. §§ 78c(a)(10) and 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, are set forth in the appendix hereto (A. 69-77).

STATEMENT OF THE CASE

A. The Transactions and Parties Involved

1. The Defendants-Petitioners

At all times material hereto John Nuveen & Co., Inc. ("Nuveen") was a broker-dealer registered with the Securities and Exchange Commission ("SEC"). In September of 1968, Nuveen acquired the business of Ashwell & Co. ("Ashwell"), a Chicago-based dealer in short-term promissory notes (hereinafter referred to as "commercial paper").* On September 15, 1969, Investors Syndicate of America, Inc.

* Commercial paper consists of unsecured, short-term promissory notes, payable to the bearer at a stated maturity, never more than 270 days. The notes are either interest-bearing notes or discount notes without interest.

("ISA"), a wholly-owned subsidiary of Investors Diversified Services, Inc. ("IDS"), acquired all of the stock of Nuveen.

2. Winter & Hirsch, Inc.

Winter & Hirsch, Inc. was one of the companies whose commercial paper was sold by Ashwell (since the 1930's) and later by Nuveen. Winter & Hirsch was a consumer finance company which had been in business in Chicago since 1915 and was held in very high regard by financial institutions. Winter & Hirsch obtained funds to lend from various sources, including unsecured bank loans, long-term loans, and the sale of commercial paper. As Nuveen knew, more than seventy banks, including forty Chicago-area banks, lent money to Winter & Hirsch during the period at issue in this case.*

3. Lieber, Bleiweis and Company

At all times material hereto, and beginning some time prior to 1960, the certified public accounting firm of Lieber, Bleiweis and Company ("Lieber, Bleiweis") and predecessors thereto issued semi-annual audited statements of Winter & Hirsch. Lieber, Bleiweis was duly licensed to practice public accounting in the State of Illinois.

Nuveen, as well as the major bank and insurance company lenders to Winter & Hirsch, all relied upon the audit reports issued by Lieber, Bleiweis. The Court of Appeals assumed for purposes of its decision (in accordance with petitioners' contention) that the reports were not defective or qualified and that "nothing in the audits themselves gave Nuveen any special reason to question their accuracy." (A. 7).

* Eleven of the fifty largest banks on the Fortune Directory were lenders to Winter & Hirsch in this period. *Fortune*, July, 1974, p. 114.

4. The Plaintiff-Respondent

Plaintiff-respondent Sanders (hereinafter "Sanders") purchased from Nuveen a $35,000 principal amount ninety-day promissory note of Winter & Hirsch.* He represents a class consisting of 43 purchasers from Nuveen of Winter & Hirsch commercial paper, all purchased prior to February 10, 1970, with an aggregate face amount of $1,600,000.**

B. Nuveen's Investigation of Winter & Hirsch

Prior to the first sale of Winter & Hirsch commercial paper at issue here, Nuveen made an extensive investigation of Winter & Hirsch. In December 1968, Nuveen's commercial paper credit analyst reviewed the most recent audited financial statements of Winter & Hirsch (as of August 31, 1968), which Lieber, Bleiweis had certified. In March 1969, the analyst spent an entire day at the main office of Winter & Hirsch meeting with its officers and making a check of its records, with particular attention to the collection procedure for delinquent accounts and to a determination of whether proper documentation supported its accounts receivable. Nothing in that on-site examination disclosed any adverse information about Winter & Hirsch.

In addition, written inquiries of banks that were lenders to Winter & Hirsch elicited generally laudatory responses.

* The note purchased by Sanders was a discount note reading as follows:

WINTER & HIRSCH, INCORPORATED
$35,000.00 January 30, 1970 No. 7351

On April 30, 1970 for value received we promise to pay to the order of bearer the sum of Thirty Five Thousand and 00/100 Dollars payable at the principal office of First National Bank of Chicago

Not Negotiable Unless Countersigned

WINTER & HIRSCH, INCORPORATED

By /s/ Sheldon Tucker
Counter Signature

By /s/ Milton Hirsch
Authorized Officer

** As a result of payments on behalf of Winter & Hirsch, net claims against the petitioners aggregate approximately $575,000, exclusive of interest.

In late 1969 a later financial statement of Winter & Hirsch, certified by Lieber, Bleiweis, was reviewed by Nuveen and in early 1970 further inquiries were made by it of bank lenders.

C. Discovery of The Winter & Hirsch Fraud

In the fall of 1969 rumors about Winter & Hirsch began to reach a few of its bank lenders, but not Nuveen. As a result of pressure from two of these lenders, on January 9, 1970 Winter & Hirsch retained another public accounting firm, Peat, Marwick, Mitchell & Co. ("Peat, Marwick"), to conduct an audit as of January 31, 1970. The circulation of the rumors and the commencement of the audit were unknown to Nuveen until February 10, 1970. Despite importunings from one of Winter & Hirsch's bank lenders, Nuveen immediately ceased selling Winter & Hirsch commercial paper. The opinions of neither the District Court nor the Court of Appeals suggested any dereliction on the part of Nuveen for not having sooner learned of these facts.

Approximately five weeks after its audit had begun, Peat, Marwick discovered a discrepancy of approximately $14,000,000 between Winter & Hirsch's actual accounts receivable and the total shown on its books and in the most recent Lieber, Bleiweis audit report. It was subsequently learned that the discrepancy resulted from a fraudulent inflation of the firm's books by the management of Winter & Hirsch, which had occurred piecemeal over a period of ten years or more. It was also determined that, despite its certificate to the contrary, Lieber, Bleiweis had not audited Winter & Hirsch but instead had relied largely on information supplied by management. The principals of both Winter & Hirsch and Lieber, Bleiweis subsequently pleaded guilty to federal criminal fraud charges.

Following discovery of the fraud all payment of Winter & Hirsch debt, including the commercial paper owned by Sanders and members of the class represented by him, was suspended.

D. Proceedings Below

On March 12, 1970, Sanders filed a class action complaint against thirteen defendants, including Nuveen, IDS, and ISA.* Sanders contended that petitioners and the other defendants violated certain provisions of the federal securities laws** in connection with the sale by Nuveen of the commercial paper issued by Winter & Hirsch during an eight-month period beginning in June, 1969.

Petitioners filed a motion in the District Court challenging, *inter alia*, that court's jurisdiction under the 1934 Act on the ground that the short-term promissory note purchased by respondent was not a "security" subject to the provisions of the 1934 Act, and its sale, therefore, could not violate the 1934 Act or any rule or regulation thereunder. The District Court denied petitioners' motion without opinion and subsequently certified to the Court of Appeals for the Seventh Circuit, pursuant to 28 U.S.C. § 1292(b), the question whether commercial paper in the form of a conventional promissory note with a maturity of

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* Nine defendants other than those named above were dismissed by stipulation with the approval of the District Court. The Court of Appeals reversed the District Court's judgment imposing liability on a tenth defendant, Alleghany Corporation.

** The complaint as amended to the time of trial asserted claims under Sections 12(2) and 17 of the 1933 Act, 15 U.S.C. §§ 77*l*(2) and 77q, respectively; Sections 10(b) and 20 of the 1934 Act, 15 U.S.C. §§ 78j(b) and 78t, respectively; Rule 10b-5 promulgated by the SEC under the 1934 Act, 17 C.F.R. § 240.10b-5, and certain of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. The holding of the Court of Appeals was based solely on Rule 10b-5 under the 1934 Act (A. 6-7), except that the liability of IDS and ISA was predicated on their alleged status as controlling persons of Nuveen under Section 20 of the 1934 Act, 15 U.S.C. § 78t. In this petition no question is raised under Section 20.

nine months or less is a "security" as defined in Section 3(a)(10) of the 1934 Act (A. 66).

The Court of Appeals granted permission to appeal and in its first opinion (*"Sanders I"*) held that the note purchased by Sanders was a "security" within the meaning of Section 3(a)(10). The court held that, although under the terms of the 1934 Act "a note with a maturity not exceeding nine months [is] withdrawn from the application of the anti-fraud provisions of the act" (A. 54), the note purchased by Sanders with a maturity of only ninety days nevertheless was a "security" subject to the antifraud provisions of the 1934 Act (A. 56-58). Accordingly, the court ordered a trial on the merits.*

Following trial the District Court found in favor of Sanders and against the petitioners (A. 20-48). After further proceedings concerning claims of individual class members and petitioners' objections thereto, the District Court sustained all claims filed and petitioners appealed.

In its second opinion in this case (*"Sanders II"*), the Court of Appeals affirmed the judgment against Nuveen, ISA and IDS and affirmed the rulings denying petitioners' objections to claims of individual class members. Specifically, the Court of Appeals adopted the reasoning and holding of its opinion in *Sanders I* as to the term "security" (A. 6, n.8) and further held that Nuveen had violated its obligations as an "underwriter" of a security, that "Nuveen's investigation of [Winter & Hirsch] was deficient, and that an appropriate investigation would have revealed the fraud." (A. 9).

* Petitioners thereafter sought certiorari to this Court. The petition was denied. 409 U.S. 1009 (1972).

REASONS FOR GRANTING THE WRIT

I. The Decision Below That Notes With A Maturity Of Less Than Nine Months Were Securities Within The Meaning Of Rule 10b-5 Under The Securities Exchange Act Of 1934 Directly Contravenes The Definition Of "Security" In That Act*

The Court of Appeals held that although all the notes in question had a maturity of less than nine months, they were nevertheless securities as defined in Section 3(a)(10) of the 1934 Act. The Court of Appeals committed error in so holding because Section 3(a)(10) of the 1934 Act explicitly states:

> "The term 'security' means any note, . . . but *shall not include* currency or *any note*, draft, bill of exchange, or banker's acceptance *which has a maturity at the time of issuance of not exceeding nine months*, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." (emphasis added)

As stated by this Court in another case under the 1934 Act:

> "[W]hatever the rationale of the proviso [in the statute], it cannot be disregarded simply on the ground that it may be inconsistent with . . . the 'wholesome purpose' of the Act.
>
> • • •
>
> "[W]e are not free to adopt a construction that not only strains, but flatly contradicts, the words of the statute." *Reliance Electric Co. v. Emerson Electric Co.* 404 U.S. 418, 424, 427 (1972).

The holding on this issue in *Sanders I* came as a surprise to the commercial paper industry, which had always con-

* This issue was the subject of the interlocutory petition for certiorari referred to in note * on page 8 *supra*. The Court of Appeals having reaffirmed its position after development of a complete record, the matter is now ripe for resolution by this Court. *See, e.g., Mercer v. Theriot*, 377 U.S. 152, 153-154 (1964); Stern and Gressman, *Supreme Court Practice* 27 (4th ed. 1969).

sidered commercial paper as excluded from the 1934 Act definition of "security". *Wall Street Journal,* November 14, 1972, p. 2 (Midwest ed.) The SEC had taken a similar position:

> ". . . commercial paper having a maturity up to 270 days is not a security for purposes of the Exchange Act of 1934." Staff Report of the S.E.C. to the Special Subcommittee on Investigations, Committee on Interstate and Foreign Commerce, *The Financial Collapse of the Penn Central Company* (Aug. 1972) at viii; *see also id.* 273-274. (hereinafter cited as *"Penn Central Report"*).*

At the time of the petition for a writ of certiorari to review the decision of the Court of Appeals in *Sanders I,* there had been only a handful of decisions construing Section 3(a)(10), including three which held that short-term notes were not securities.** Since denial of that petition, however, a number of cases have followed the holding or rationale of *Sanders I* (holding either that short-term notes were securities, *e.g., Zeller v. Bogue Electric Manufacturing Corp.,* 476 F.2d 795 (2nd Cir. 1973), *cert. denied,* 414 U.S. 908 (1973), or that longer-term notes were not securities, *McClure v. First National Bank,* 497 F.2d 490 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975)). Some of these decisions have reached such results with explicit recognition of the violence done to the statutory language:

* The report noted that the opinion in *Sanders I* reached a contrary result, having applied to Section 3(a)(10) of the 1934 Act a standard appearing only in the 1933 Act. *Id.* 274, n. 4. *See* Part IV-2 *infra.*

** *Investment Properties Int'l, Ltd. v. I.O.S.,* CCH Fed.Sec.L.Rep ¶ 93,011 at 90,726 (S.D.N.Y. 1971) [1970-71 Transfer Binder]; *Securities and Exchange Commission v. Fifth Avenue Coach Lines, Inc.,* 289 F.Supp. 3, 38 (S.D.N.Y. 1968), *aff'd,* 435 F.2d 510 (2d Cir. 1970); *Superintendent of Insurance v. Bankers Life and Casualty Co.,* 300 F. Supp. 1083, 1100 (S.D.N.Y. 1969), *aff'd,* 430 F.2d 355 (2d Cir. 1970), *rev'd on other grounds,* 404 U.S. 6 (1971).

> "We realize that our holding today [interpreting Section 3(a)(10) of the 1934 Act] that the Act does not apply to commercial notes of a longer duration than nine months, taken with the decisions voiding the short-term exemption as to investment paper, virtually writes that exemption out of the law. . . . The original scrivener of the definitional section may well wonder what happened to his carefully drawn exemption on the way to the courthouse, but if the judicial decisions do not properly reflect the intent of Congress as to the coverage of the Act, only that body can properly rectify the situation at this point, if stare decisis is to apply and the Supreme Court does not make some definitive decision contrary to the presently decided cases." *McClure v. First National Bank,* 497 F.2d 490, 494-495 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975).

The foregoing language was quoted by the Court of Appeals for the Seventh Circuit in *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.,* 508 F.2d 1354, 1360 n. 13 (7th Cir. 1975), *cert. denied,* 96 S.Ct. 38 (1975).* The instant case affords an appropriate opportunity for this Court to "rectify the situation" by making a "definitive decision contrary to the presently decided cases."

As of the end of September, 1975, the amount of commercial paper outstanding in the United States exceeded 48.2 billion dollars in principal amount, of which 17.8 billion was dealer-placed.** The enormous dollar amounts involved in sales of commercial paper underscore the need for a definitive decision by this Court as to whether commercial paper is a security subject to the 1934 Act. Resolution of this basic definitional question takes on added importance in light of the expanded duties of investigation

* Although certiorari was denied in *McClure* and in *C.N.S. Enterprises, Inc.,* both cases held that notes with a maturity of longer than nine months were *not* securities, rather than the reverse.

** FEDERAL RESERVE BULLETIN, December, 1975, vol. 61 at A-25. As reported therein, 12.2 billion issued by non-financial companies is not separated between dealer-placed and directly-placed; however, petitioners understand that paper issued by non-financial companies is dealer-placed, not directly-placed.

and exposure to civil liability under the 1934 Act which the decision below will impose upon commercial paper dealers.*

II. The Decision Below Presents Important Additional Perspectives As To The *Scienter* Issue Under Rule 10b-5 That Is Before This Court In *Ernst & Ernst v. Hochfelder*

In *Sanders II* the Court of Appeals described the principal question at issue therein as

> "whether an underwriter of short term commercial paper, who acted in the *mistaken but honest belief*** that financial statements prepared by certified public accountants correctly represented the condition of the issuer is liable to its customers for losses sustained as a result of the issuer's default." (A. 1) (emphasis and footnote added).

In posing this question the court below assumed that the audit reports were appropriately certified and that nothing in the audit gave Nuveen any special reason to question their accuracy (A. 7). Nevertheless, the court answered the basic question in the affirmative and held that Nuveen, which it denominated an "underwriter"***, "breached a duty to make reasonable inquiries that would have led to the discovery of the issuer's fraud" (A. 1). It thus imposed liability under Rule 10b-5 without requiring any showing of *scienter, i.e.,* intent to defraud, actual knowledge of misrepresentations or omissions, or a willful, deliberate or reckless disregard for the truth that is the equivalent of knowledge. *Lanza v. Drexel & Co.,* 479 F.2d 1277, 1305 (2d Cir. 1973).

* The separate question of exemption of commercial paper from the registration provisions of the 1933 Act will be treated below as part of the discussion of the duty of investigation that should be required of a commercial paper dealer. (Part IV-2 *infra*).

** Nuveen's "honest belief" as to the condition of the issuer was not the result of a blind acceptance of statements by Winter & Hirsch and its auditors. Its belief was based on its extensive and continuing investigation of Winter & Hirsch which included but went well beyond the audit reports. *See* pp. 5-6 *supra*.

*** As discussed in Part III *infra*, the court erroneously characterized Nuveen as an underwriter for purposes of invoking an underwriter's duty of investigation akin to—or beyond—that of Section 11 of the 1933 Act.

1. This Court Has Granted a Petition for a Writ of Certiorari and Has Heard Oral Argument in *Ernst & Ernst v. Hochfelder,* Raising Similar Issues With Regard to Accountants

In *Sanders II* the court below specifically stated that "Nuveen's liability in this case must rest on Rule 10b-5" (A. 6); yet it upheld Nuveen's liability as a dealer in commercial paper on the basis of proof of, at most, negligence. A similar holding with respect to independent auditors is currently before this Court in *Ernst & Ernst v. Hochfelder,* 503 F.2d 1100 (7th Cir. 1974), *cert. granted,* 421 U.S. 909 (1975) (No. 74-1042).* The instant case presents a *scienter* issue similar to that of *Ernst & Ernst* in the context of the market for commercial paper, an extremely important and vital aspect of American capital markets, and it also necessarily raises that issue in relation to the duties of dealers generally. Moreover, this case, like *Ernst & Ernst,* involves an alleged breach of a duty to make inquiry, rather than an affirmative misrepresentation.

While this case involves issues not involved in *Ernst & Ernst,* if this Court holds in *Ernst and Ernst* that negligence may not support liability under Rule 10b-5, petitioners urge this Court to grant this petition and reverse summarily.

2. A Conflict Between Circuits Exists on the Question Whether Civil Liability Under Rule 10b-5 Can Be Based on Negligence

As apparently recognized by this Court when it granted the petition for certiorari in *Ernst & Ernst v. Hochfelder,* there is a conflict of authority among federal courts of

* The Court granted a petition for a writ of certiorari in *Ernst & Ernst* on the following question: "1. Whether Respondents may predicate a cause of action against Petitioner for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, on an allegation of negligence in the absence of any allegation of deliberate or intentional fraud or reckless or willful conduct or of knowledge of such fraud or conduct on the part of Petitioner?" Petition for Writ of Certiorari, 421 U.S. 909 (1975).

appeals on the question whether civil liability under Rule 10b-5 may be based on negligence. The Second, Fifth and Tenth Circuits have held that negligence will not support an action under Rule 10b-5;* the Seventh, Eighth and Ninth Circuits have disagreed;** and the other Circuits have not yet definitively addressed the question.*** The instant case is another decision of the Seventh Circuit applying a negligence standard.

3. The Language of Section 10(b) and of Rule 10b-5 Does Not Permit Liability Based on Negligence

Section 10(b), which prohibits "any manipulative or deceptive device or contrivance", on its face requires conduct connoting fraud. If and to the extent that Rule 10b-5 is construed to support liability in damages for conduct which amounts only to negligence, the rule would be beyond the scope of the statute and therefore invalid. 6 Loss, *Securities Regulation* 3884 (Supp. to 2d ed., 1969); *cf. Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969).

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* Second Circuit: In *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971), a case involving a brokerage firm, the Second Circuit has stated that the plaintiff's claim was not actionable under Rule 10b-5 "in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud." 448 F.2d 442, 445. *See also Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) ("proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5."); Fifth Circuit: *Vohs v. Dickson*, 495 F.2d 607, 622 (5th Cir. 1974) ("some culpability beyond mere negligence"); Tenth Circuit: *Clegg v. Conk*, 507 F.2d 1351, 1361 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975) ("there is required something additional by way of scienter or conscious fault than mere negligence. . . .").

** The two circuits other than the Seventh Circuit have held, in cases involving misrepresentations, that negligence is an appropriate standard: Eighth Circuit: *Vanderboom v. Sexton*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); Ninth Circuit: *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974) (adopting a flexible duty standard); *Robinson v. Cupples Container Co.*, 513 F.2d 1274, 1278 (9th Cir. 1975); *Clark v. Watchie*, 513 F.2d 994, 999 (9th Cir. 1975), *cert. denied*, 96 S.Ct. 72 (1975).

*** The Sixth Circuit has addressed the question in a narrow injunction setting: *Securities and Exchange Commission v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975) (conscious intent required in an aiding and abetting injunction case).

Further, the language of Rule 10b-5 as applied to this case requires a showing greater than negligence. The court below did not base its conclusion upon any transmission of information by Nuveen to members of the class, but rather stated that "the relationship between the underwriter and its customers *implicitly* involves a favorable recommendation of the issued security" (A. 8) (emphasis added). Since the court imposed liability on a theory not involving any affirmative misrepresentation, clause (2) of Rule 10b-5 is inapplicable. Liability must therefore rest on one of the two other clauses, both of which use classic fraud language, to wit: "(1) to employ any device, scheme, or artifice to defraud, . . . (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, . . ." The words "defraud" and "fraud or deceit" surely require a degree of culpability greater than negligence, as the Courts of Appeals of the Second, Fifth and Tenth circuits have held. *See* cases cited in note * page 14 *supra*.

The following statement of this Court, in a very recent case construing an express liability provision of the 1934 Act, is *a fortiori* pertinent in a case involving a claim of implied liability under Section 10(b) of the 1934 Act and Rule 10b-5:

> "It is inappropriate to reach the harsh result of imposing § 16(b)'s liability without fault on the basis of unclear language. If Congress wishes to impose such liability, we must assume it will do so expressly or by unmistakable inference." *Foremost-McKesson, Inc. v. Provident Securities Co.*, 44 U.S.L.W. 4056, 4062 (January 13, 1976).

III. In Creating An Implied Liability Under Rule 10b-5 That Exceeds The Bounds Of Comparable Express Liability Provisions, The Decision Below Is Contrary To The Doctrine Of *Blue Chip Stamps v. Manor Drug Stores*

In *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975), this Court held that a plaintiff who had neither purchased nor sold securities did not have standing to bring an action under Rule 10b-5. In so holding, the Court turned for guidance to the "principal express nonderivative private civil remedies" of the federal securities laws, *viz.,* Sections 11 and 12 of the 1933 Act and Sections 9 and 18 of the 1934 Act. 421 U.S. at 735-736. After examining those sections this Court stated, "It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action." 421 U.S. at 736. This Court thus indicated that in situations analogous to those for which private express remedies were created under the federal securities laws Rule 10b-5 must be construed as containing the limitations which are set forth in those express statutory provisions. The court below erred in failing to follow that principle.

1. In Concluding That a Commercial Paper Dealer May Not Rely on an Unqualified Audit Report But Must Examine the Independent Accountants' Underlying Work Papers, the Decision Below Imposed a Greater Burden on Such a Dealer For Purposes of Implied Liability Under Rule 10b-5 Than Is Imposed on an Underwriter Under Section 11 of the Securities Act of 1933

In *Sanders II,* the Court of Appeals held that under Rule 10b-5 Nuveen was not entitled to rely on an unqualified

certified audit report by a firm of independent accountants to conclude that Winter & Hirsch was in good financial condition. Rather, the court stated that Nuveen should have examined the independent accountants' underlying work papers (A. 7). This burden is far greater than that which Congress placed on an underwriter of a public offering of securities registered under the 1933 Act, which was specifically tailored by Congress to protect the investing public in connection with distributions of securities and to allocate liabilities in connection therewith.

Liability of an underwriter in a registered public offering is determined under Section 11 of the 1933 Act, a detailed civil liability provision which contains a number of defenses available to underwriters and others. Those defenses include one that

> "no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof . . . that . . . as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) . . . he had no reasonable ground to believe, and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, ..." Section 11(b)(3)(C), 15 U.S.C. § 77k(b)(3)(C).

In other words, an underwriter in a registered offering has no affirmative duty to verify the accuracy of the report of an expert, such as an independent public accountant, unless he has reasonable ground to believe the report to be inaccurate. *Escott v. BarChris Construction Corp.,* 283 F.Supp. 643, 697 (S.D.N.Y. 1968).

By imposing a duty of verification of an accountants' report upon Nuveen, despite its "honest belief" (A. 1) that

the certified financial statements correctly represented the financial condition of the issuer, the decision below is manifestly inconsistent with the doctrine of *Blue Chip Stamps*. Moreover, petitioners are unaware of *any* case requiring a seller of securities to verify an accountants' report which it reasonably believed to be correct.

2. The Decision Below Otherwise Improperly Disregarded the Statutory Pattern of Express Civil Liabilities of the Federal Securities Laws

The holding in *Sanders II* that Nuveen had an underwriter's duty of investigation is also inconsistent with *Blue Chip Stamps*.

In Sections 11, 12(1) and 12(2) of the 1933 Act, Congress carefully established a system of remedies for buyers of securities. Section 11 is available to buyers of securities issued pursuant to a false registration statement, Section 12(1) is available when securities are sold in violation of the registration requirements of Section 5, and Section 12(2) is available when securities, whether or not required to be registered, are sold by means of a false written or oral communication.

The Court of Appeals expressly recognized that Section 11 was not applicable in the instant case because there was no registration statement (A. 6). It also expressly recognized that Section 12(2) was not applicable because there was no finding of violation as to any written or oral communication and there was no evidence of reliance on express recommendations by Nuveen (A. 6-7). Yet the court, looking solely to Rule 10b-5 as the basis for implied liability, imposed upon Nuveen as an "underwriter" of commercial paper* a duty of investigation at a substantially higher

* The court's statement that "The conclusion that Nuveen was an underwriter for Winter & Hirsch is not challenged" (A. 3) misconstrues petitioners' position. If, contrary to petitioners' position, commercial

threshold than the duty of reasonable care imposed under Section 12(2) of the 1933 Act on sellers of securities generally.*

Notwithstanding that it found Section 11 of the 1933 Act inapplicable, the court below relied primarily on Section 11 cases regarding special obligations of underwriters of registered offerings,** and thus ignored the statutory distinction between offerings registered under the 1933 Act and other sales. In particular, the court stated that, "[w]hether reviewing the underwriter's duty to investigate under the standards of § 11 applicable to registration statements or under the standards of Rule 10b-5," the following passage from *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968) is pertinent:

> "To effectuate the statute's purpose the phrase 'reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company." (A. 8-9, n. 18.)

* (Continued)
paper is a security for purposes of Rule 10b-5 under the 1934 Act, a commercial paper dealer might literally come within the definition of "underwriter" found in the 1933 Act, which includes "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, . . ." Section 2(11), 15 U.S.C. § 77b(11). But this still does not mean (as petitioners have consistently argued) that the Section 11 standards, which are applied to underwriters of offerings covered by 1933 Act registration statements, are applicable under Rule 10b-5 to sales not involving a registration statement. This is the critical question.

* And, with respect to reliance on an unqualified audit report, a duty even higher than that imposed on 1933 Act underwriters. *See* Part III-1 *supra*.

** Thus, the court cited with approval two cases involving registration statements decided under Section 11, *Feit v. Leasco Data Processing Corp.*, 332 F.Supp. 544, 581 (E.D.N.Y. 1971) (A. 8, n. 16) and *Escott v. BarChris Construction Corp.*, 283 F.Supp. 643 (S.D.N.Y. 1968) (A. 8-9, n. 18). It also referred to *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), *cert. denied*, 414 U.S. 910 (1973), a case discussing the duties which an underwriter owes "to pass on the soundness of the security and the correctness of the registration statement and prospectus" (A. 8, n. 17).

But the words "reasonable investigation" emphasized in this passage (as well as the word "underwriter") appear only in Section 11, not in Section 12(2) of the 1933 Act or in Rule 10b-5. In Section 12(2), the provision dealing with liabilities of sellers generally, there is no singling out of a category of underwriters. Liability is predicated on use of communications which the seller knew or "in the exercise of reasonable care could . . . have known" were untrue or misleading. Congress obviously used different language in dealing with different situations, and other courts have emphasized the importance of the difference: an affirmative, active duty of investigation in the case of a registered offering, a more passive duty of vigilance in the case of sellers generally. *See Levine v. Securities and Exchange Commission*, 436 F.2d 88 (2d Cir. 1971);* *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (drawing a sharp distinction between Section 11 and non-Section 11 sales of securities with respect to directors' duty to investigate).** *See also* the following statement by the SEC in August 1972, contrasting disclosure and investigation practices for offerings registered under the 1933 Act and typical commercial paper sales:

> "In the absence of registration requirements, there are no customary standards requiring disclosure of material information, to the extent the same is disclosed in a statutory prospectus, to purchasers. . . . Furthermore, there is no investigation undertaken by the dealer which would even approximate that which is required of an underwriter of a security offering registered . . .

* "Of course, absent actual knowledge or warning signals, a broker-dealer should not be under a duty to retain his own auditor to re-examine the books of every company, the stock of which he may offer for sale, even accepting the doubtful hypothesis that such permission would be granted." 436 F.2d at 90.

** "Congress chose to impose upon directors through Section 11 of the 1933 Act a duty to insure that all material, adverse information is conveyed to prospective purchasers of the Company's stock. The history of the section demonstrates that the matter was carefully considered and the duties were precisely defined. *To argue that a section of the 1934 Act,*

pursuant to the 1933 Act." *Penn Central Report* at 273-274.*

Under the *Blue Chip Stamps* doctrine this distinction, built into the express liability provisions, between the "reasonable investigation" duty of an "underwriter" in a registered offering and the "reasonable care" standard applicable to other types of sellers and sales may not be disregarded, as the Court of Appeals did in *Sanders II* in creating an implied liability under Rule 10b-5.** The end result of ignoring this distinction is to turn Rule 10b-5's prohibition of fraud and deception into an affirmative obligation that is unrealistic and unworkable in relation to the commercial paper market.***

** (Continued)
which neither by its terms nor its history manifests a similar attention to the careful balance struck in Section 11, and which would impose upon directors the same duties as Section 11 and more, is to thwart, not to serve, the purpose of Congress and the dictates of sound policy. . . ." 479 F.2d at 1309 (emphasis added).

* Although recommending legislative changes, the SEC made no suggestion that the differing practices described were illegal under existing law.

** Petitioners recognize that in administrative proceedings involving broker-dealer conduct the SEC has sometimes extended the Section 11 duty of investigation, or something akin thereto, to exempt offerings. *See SEC Release No. 33-5275* (July 26, 1972); *Leonard Lazaroff, SEC Release No. 34-7940* (August 22, 1966); *Charles E. Bailey & Co.*, 35 S.E.C. 33 (1953). But even if the SEC is correct in this position, which petitioners do not concede, the SEC has itself recognized, as have the courts, that standards applied in administrative or injunctive proceedings are not necessarily applicable in damage cases as a matter of implied liability. *E.g.*, Brief for the SEC as Amicus Curiae on Writ of Certiorari to the Court of Appeals for the Seventh Circuit in *Ernst & Ernst v. Hochfelder*, 503 F.2d 1100 (7th Cir. 1974), *cert. granted*, 421 U.S. 909 (1975) (No. 74-1042), pp. 8, 23-33; *Securities and Exchange Commission v. Spectrum, Ltd.*, 489 F.2d 535, 542 (2d Cir. 1973); *Hanly v. Securities and Exchange Commission*, 415 F.2d 589, 596 (2d Cir. 1969).

*** The crowning difficulty with the holding of the court below, of course, is that liability was found in a situation of "honest but mistaken belief"—*i.e.*, in the absence of *scienter*—as discussed in Part II *supra*.

IV. The Decision Below Establishes An Unrealistic And Unworkable Duty Of Investigation, Which Is Likely To Have A Materially Adverse Impact On The Commercial Paper Market

1. The Decision of the Court of Appeals Ignores the Unique Nature of Commercial Paper

Commercial paper is a debt instrument of very short maturity with virtually no secondary market. Thus, factors which might influence other investment decisions involving equity securities or long-term debt (such as long-term profitability, revenue and cost trends, competitive factors, environmental factors and the like) are irrelevant in the case of commercial paper. The important consideration insofar as commercial paper is concerned is the ability of the issuer to pay the notes when they mature. As a result, investigation and analysis will concentrate on the issuer's ability to provide cash by ordinary operations or by borrowing from other sources, such as bank lines of credit, which in turn means focusing on the issuer's current financial statements and its relationship with other lenders, such as banks.*

Therefore, the most crucial concern for a commercial paper purchaser is the integrity of the issuer's current financial statements. These statements are the responsibility of the independent public accountants who certify, *inter alia,* that the receivables shown on the balance sheet exist and appear to be collectible (or that the reserve for bad debts is adequate) and that the liabilities are accurately stated.

* A finance company, such as Winter & Hirsch, is further unique. Its existence is centered on financial transactions in the purest sense. It borrows money; it lends money after checking the credit-worthiness of the borrower and, possibly, the value of the collateral; it collects money owed it; and it pursues delinquent accounts.

The Court of Appeals paid lip service to these factors (A. 9-10) but still imposed an unrealistic and excessive burden of inquiry. Because a gross fraud had been perpetrated by Winter & Hirsch and its outside accountants, the court in effect framed the duty of inquiry in terms of what might have been done to detect the fraud (A. 7-11).

Even an accounting firm rendering an opinion on the financial statements of an issuer does not purport to certify that the issuer has not committed a fraud. *Statement of Auditing Procedure No. 33* ch. 1, para. 5 (AICPA 1963). Inquiries of the kinds that the court below thought Nuveen should have undertaken might theoretically be possible, but would be quite impractical, in the commercial paper market. For example, to examine an accountant's underlying work papers (assuming they would be made available) would require hiring another accountant to audit the work of the issuer's auditor. Likewise, a dealer might need to employ an accountant or legal counsel to examine and understand the significance of an issuer's tax returns or minute books. But the cost of hiring such persons would be prohibitive in light of the relatively low mark-ups normally involved in the marketing of short-term commercial paper as compared with underwriting spreads normally involved in long-term debt or equity financing. Thus, if the duty of inquiry as defined in the instant case were to be applied generally, the commercial paper market would soon be closed to those companies that must rely on dealers to place their paper.

Even under Section 11 an underwriter has a defense of "reasonable investigation." In the circumstances of this case, involving sale of commercial paper of a finance company, the investigation that Nuveen made (*see* pp. 5-6 *supra*) should have been found adequate under this or any other reasonable standard, even though it failed to detect the issuer's and its accountants' fraud. This is especially true

considering that numerous lending banks, including major ones located in the vicinity of the issuer, failed to detect the same fraud while presumably exercising reasonable care to protect their own funds.*

2. As a Consequence of the Court of Appeals' Decision, Concealed Fraud by the Issuer of Commercial Paper Would Preclude Exemption From the 1933 Act's Registration Requirement and Would Make Every Commercial Paper Dealer a Virtual Insurer

An unreasonable burden was placed on commercial paper dealers for still another reason, related to Part I above.

In reaching its decision that the short-term notes in this case were securities under the 1934 Act, the Court of Appeals relied upon material relevant to the 1933 Act's exemption for short-term notes.** In essence, the court's approach was that if the commercial paper in question was not an exempt security under the 1933 Act,*** it was not entitled to exclusion from the definition of security in Section 3(a)

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* The Court of Appeals seemingly acknowledged that if Nuveen's obligation were "to comply with the standard applicable to a broker-dealer who had recommended the purchase of a security" it would have met its duty by reliance on published data and would not have been required to discharge an additional duty of investigation (A. 9). *See also Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 371 (2d Cir. 1973), *cert. denied*, 414 U.S. 910, 924 (1973).

** *See* discussion in *Sanders I* (A. 55-57).

*** In contrast to the 1934 Act, the 1933 Act does not exclude short-term notes from the definition of security; rather, Section 3(a)(3) expressly exempts such notes from the registration requirements of that Act, by the following language:

> "3(a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:
>
> • • •
>
> "(3) any note, draft, bill of exchange, or bankers' acceptance *which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions*, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited; . . ." (emphasis added).

The italicized language appears in the 1933 Act exemption but not in the 1934 Act definition.

(10) of the 1934 Act (A. 56). In so holding, the court not only took the unwarranted step of reading into Section 3(a)(10) of the 1934 Act a provision of Section 3(a)(3) of the 1933 Act (which led to a reading of Section 3(a)(10) opposite to that of the SEC's, *see Penn Central Report* at 273-274), but it then proceeded, petitioners submit, to misread the SEC's interpretation of the words thus improperly injected into Section 3(a)(10).

Specifically, the court below relied on *SEC Release No. 33-4412* (September 20, 1961), interpreting Section 3(a)(3) of the 1933 Act. Despite the fact that the release explicitly stated that "A type of security which usually has been considered to fall within the terms of Section 3(a)(3) is short-term paper issued by finance companies to carry their installment loans", the court below focused on the following language in the release:

> ". . . section 3(a)(3) applied only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well-recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks."

In interpreting and applying this paragraph, the court concluded that, although Winter & Hirsch's insolvency was not known to the petitioners at the time of sale of the paper, the fact of insolvency meant that the paper was neither "prime quality" nor "eligible for discounting" by federal reserve banks (A. 55-56).

Retracing the steps in the court's reasoning and applying this conclusion to the exemptive language of the 1933 Act, the effect would necessarily be that, where the issuer and its accountants are engaged in a massive fraud, in the event of the insolvency of the issuer the risk of liability under Sec-

tion 12(1) of the 1933 Act for the sale of unregistered securities (*i.e.*, the commercial paper which, in view of the insolvency, could not have been "prime quality") falls directly on the dealer, no matter how extensive the dealer's investigation.

The liability of sellers of securities under the express anti-fraud liability provision of the 1933 and 1934 Acts is, generally, not absolute but rather is dependent upon the extent of the seller's knowledge or investigation of the facts. *See, e.g.*, Sections 11 and 12(2) of the 1933 Act, Sections 9 and 18 of the 1934 Act. On the other hand, under Section 12(1) of the 1933 Act liability is virtually absolute. If by hindsight, after discovery of fraudulently concealed insolvency, a court can determine that the exemption from registration normally available to commercial paper was not available, then a questionable anti-fraud claim will become a virtually certain claim for the sale of unregistered securities.

If a court can thus retrospectively determine the status of commercial paper vis-a-vis the registration requirements, *i.e.*, if dealers in commercial paper must wait to see whether the paper is paid at maturity before they know whether an exemption from 1933 Act registration was available, they may be subject to liability without regard to the nature or extent of their investigation. This erroneous view of the prime quality and discounting aspects of *SEC Release No. 33-4412* interpreting Section 3(a)(3) would alone be sufficient reason for this Court to grant this petition for certiorari.*

* Petitioners should not be understood to accept *Release No. 33-4412* as being otherwise an accurate interpretation of Section 3(a)(3).

CONCLUSION

For the reasons given, petitioners pray that a writ be granted to review the judgment and opinion below. If the Court holds in *Ernst & Ernst* that *scienter* is a requirement of liability under Rule 10b-5, petitioners pray that the writ be granted and that the judgment below be summarily reversed.

Respectfully submitted,

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